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SUBJECT: IMPACT OF ANOTHER OIL PRICE INCREASE

1. PARAS 2 TO 21 PROVIDE TEXT OF TECHNICAL ANALYSIS
OF IMPACT OF ANOTHER OPEC OIL PRICE INCREASE.

SUMMARY

2. EACH 5 PERCENT OIL PRICE RISE WOULD REDUCE REAL GNP BY
0.3 PERCENT AND ADD A SIMILAR AMOUNT TO CONSUMER PRICES IN
THE MAJOR DEVELOPED COUNTRIES AS A GROUP. (THE MAJOR
DEVELOPED COUNTRIES IN ORDER OF GNP SIZE, THE UNITED
STATES, JAPAN, WEST GERMANY, FRANCE, UNITED KINGDOM,
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ITALY, AND CANADA, ALSO REFERRED TO AS THE BIG SEVEN.)
THE UNITED STATES WOULD LOSE TWO-TENTHS OF ONE PERCENT
IN REAL GNP FOR EACH 5 PERCENT OIL PRICE INCREASE. THE
TRADE IMPACT WOULD ALSO BE SUBSTANTIAL, CAUSING A NEARLY

$4 BILLION DETERIORATION IN BIG SEVEN OIL AND NON-OIL TRADE BALANCES FOR EVERY 5 PERCENT OPEC PRICE INCREASE. TAKEN AS A GROUP THE SMALLER DEVELOPED COUNTRIES WOULD EXPERIENCE MORE THAN A $1 BILLION DETERIORATION IN THEIR TOTAL TRADE BALANCE. FOR NON-OIL LDCS, RAISING OIL PRICES BY 5 PERCENT WOULD ADD OVER $1 BILLION TO THE OIL AND NON-OIL IMPORT COSTS FOR THE GROUP AS A WHOLE. END SUMMARY.

IMPACT ON INDUSTRIAL COUNTRIES

3. THE ANALYSIS THAT FOLLOWS REPRESENTS A CALCULATION OF THE POTENTIAL IMPACT OF EACH 5 PERCENT JUMP IN OPEC OIL PRICES THIS DECEMBER, UNDER CERTAIN IMPORTANT ASSUMPTIONS ABOUT GOVERNMENT POLICIES IN THE MAJOR DEVELOPED COUNTRIES. WE ASSUME (A) THAT FISCAL POLICIES ARE NOT ADJUSTED EITHER TO OFFSET OR TO REINFORCE THE CONTRACTIONARY EFFECTS OF AN OIL PRICE HIKE AND (B) THAT MONETARY POLICY IS NEUTRAL, I.E., MONEY SUPPLY IS PERMITTED TO ADJUST TO CHANGES IN THE DEMAND FOR MONEY DUE TO OIL PRICE HIKES. IN REALITY, POLICY REACTIONS WILL DIFFER WIDELY FROM COUNTRY TO COUNTRY, AND NO ONE CAN PREJUDGE THE ACTION THAT WILL BE TAKEN. GOVERNMENTS MOST CONCERNED ABOUT THE INFLATION AND BALANCE-OF-PAYMENTS IMPLICATIONS OF HIGHER OIL PRICES MAY SHOW RESPONSES AT THE OPPOSITE END OF THE RANGE FROM THOSE MADE BY GROWTH-ORIENTED GOVERNMENTS.

4. WITH ECONOMIC RECOVERY IN MAJOR COUNTRIES ALREADY SLOWED, THE PROSPECTIVE OIL PRICE HIKE POSES A PARTICULARLY SERIOUS THREAT TO THE STRENGTH OF THE UPTURN. THE RISKS ARE HEIGHTENED AT THIS TIME BECAUSE A CONTINUED RECOVERY DEPENDS ON A REBOUND IN BUSINESS INVESTMENT EARLY NEXT YEAR. IN ANY EVENT, EACH 5 PERCENT PRICE INCREASE THIS TIME WILL HAVE A SUBSTANTIALLY GREATER IMPACT ON BOTH INFLATION AND REAL GNP THAN COMPARABLE PERCENT INCREASES THREE YEARS AGO. THIS

REFLECTS THE FACT THAT HIGHER PRICES SINCE 1973 HAVE SHARPLY INCREASED THE IMPORTANCE OF OIL IN EACH OF THE MAJOR ECONOMIES. FOR THE BIG SEVEN AS A GROUP, NET OIL IMPORTS ARE NOW EQUIVALENT TO ALMOST 3 PERCENT OF GNP, COMPARED WITH LESS THAN 1 PERCENT IN 1973.

REAL GNP IMPACT

5. EACH 5 PERCENT INCREASE IN OIL PRICES WOULD REDUCE BIG SEVEN REAL GNP APPROXIMATELY $11 BILLION OR ABOUT 0.3 PERCENT BELOW WHAT IT WOULD OTHERWISE HAVE BEEN IN 1977. THE UNITED STATES WOULD LOSE 0.2 PERCENT. THESE

CALCULATIONS ASSUME THAT GOVERNMENTS TAKE NO FISCAL POLICY ACTION REINFORCING THE CONTRACTIONARY IMPACT ON DEMAND, AS THEY DID FOLLOWING THE 1973 PRICE HIKES, AND THAT MONETARY POLICIES ARE ADJUSTED TO TAKE ACCOUNT OF THE OIL-RELATED RISE IN INFLATION AND REDUCED RATES OF REAL GROWTH. THE IMPACT COULD BE WORSE IF HOUSEHOLDS REACT BY INCREASING SAVINGS RATES IN RESPONSE TO THE HIGHER INFLATION AND ANY OIL-RELATED JOB LOSSES. THE

CALCULATED LOSS IN GNP DOES TAKE ACCOUNT OF OFFSETTING GAINS FROM INCREASED BIG SEVEN EXPORTS TO OPEC DUE TO THE ADDITIONAL REVENUES HIGHER OIL PRICES BRING THE OPEC GROUP. GNP LOSSES WOULD RAISE THE NUMBER OF UNEMPLOYED IN MOST MAJOR COUNTRIES BY AN ESTIMATED 0.2 PERCENT FOR EACH 5 PERCENT RISE IN OIL PRICES.

INFLATION IMPACT

6. HIGHER OIL PRICES WOULD ADD SUBSTANTIALLY TO THE RATE OF INFLATION IN MAJOR COUNTRIES. GENERAL PRICE LEVELS, AS MEASURED BY THE GNP DEFLATOR, WOULD BE INCREASED BY MORE THAN 0.3 PERCENT ON AVERAGE FOR EVERY 5 PERCENT OIL PRICE RISE. THE RISE IN CONSUMER PRICES WOULD BE ROUGHLY THE SAME. THE UNITED STATES WOULD BE MORE VULNERABLE TO THE INFLATIONARY IMPACT OF AN OPEC PRICE RISE THAN IN THE PAST, SINCE IMPORTS NOW ACCOUNT FOR 40 PERCENT OF US OIL SUPPLIES.

7. FOR OTHER MAJOR COUNTRIES THE INFLATIONARY EFFECTS

OF AN OIL PRICE INCREASE NOW WOULD BE TWICE AS LARGE AS A SIMILAR HIKE THREE YEARS AGO. THE RISE IN CRUDE PRICES SINCE 1973 HAS DOUBLED THE SHARE OF OIL IN INDUSTRIAL PRODUCTION COSTS, RAISING IT FROM 4 PERCENT TO ABOUT 8 PERCENT. IN ADDITION TO THE DIRECT IMPACT ON PRODUCTION COSTS, HIGHER OIL PRICES WILL ADD INDIRECTLY TO INFLATION PRESSURES BY FUELING WAGE DEMANDS. WE CALCULATE THAT THESE SECONDARY EFFECTS WILL ACCOUNT FOR ONE-THIRD OF THE OIL-INDUCED PRICE INCREASE. SINCE WE HAVE NOT COUNTED OTHER SECONDARY EFFECTS, SUCH AS TRANS-MISSION OF INFLATION FROM COUNTRY TO COUNTRY, OUR CALCULATIONS UNDERSTATE THE INFLATIONARY IMPACT OF HIGHER OIL PRICES.

TRADE IMPACT

8. EACH 5 PERCENT OIL PRICE HIKE WOULD CAUSE A NEARLY $4 BILLION DETERIORATION IN THE TOTAL TRADE BALANCE OF THE BIG SEVEN. THEIR NET OIL IMPORT BILL WILL INCREASE BY NEARLY $5 BILLION, WITH THE UNITED STATES ACCOUNTING

FOR MORE THAN ONE-THIRD OF THE RISE. HIGHER OIL BILLS WILL BE ONLY PARTLY OFFSET BY INCREASED SALES TO OPEC MEMBERS BECAUSE OF ADDITIONAL REVENUES EARNED FROM HIGHER OIL PRICES. WE ESTIMATE THAT FOR EVERY 5 PERCENT OIL PRICE HIKE, THE PRICE-INDUCED RISE IN EXPORTS TO OPEC WOULD AMOUNT TO $1 BILLION NEXT YEAR FOR THE BIG SEVEN AS A GROUP.

9. BECAUSE OF THE CONTRACTIONARY IMPACT OF OIL PRICES ON DEMAND, THE BIG SEVEN TRADE BALANCE WITH NON-OPEC AREAS WOULD SHOW A POSITIVE SWING OF SOMEWHAT LESS THAN $200 MILLION FOR EACH 5 PERCENT OIL PRICE RISE. THE GAIN OCCURS PRIMARILY BECAUSE THE OIL-RELATED LOSS IN MAJOR COUNTRY IMPORT DEMAND WOULD EXCEED THE LOSS IN EXPORT SALES TO NON-OPEC AREAS.

10. ACCORDING TO OUR CALCULATIONS, FOR EACH 5 PERCENT OIL PRICE RISE, BIG SEVEN PURCHASES FROM THE SMALLER INDUSTRIAL COUNTRIES WOULD DECLINE BY APPROXIMATELY $600 MILLION IN 1977 WHILE THEIR SALES TO THESE COUNTRIES WOULD DECLINE BY $430 MILLION. ONLY A PART OF THIS

DETERIORATION IN THE NON-OIL TRADE BALANCE OF THE SMALLER COUNTRIES WOULD BE OFFSET BY INCREASED SALES TO OPEC. BECAUSE THEIR NET OIL BILL WOULD INCREASE BY $930 MILLION IN 1977, SMALLER DEVELOPED COUNTRIES WOULD EXPERIENCE A DETERIORATION OF $1.2 BILLION IN THE TOTAL TRADE BALANCE FOR EVERY 5 PERCENT OIL PRICE RISE.

IMPACT ON DEVELOPING COUNTRIES

11. FOR NON-OPEC LDCS THE CHIEF IMPACT OF HIGHER OIL PRICES WILL BE ON THEIR FOREIGN ECONOMIC POSITION. THE PRICE RISE WOULD WORSEN THEIR ALREADY SERIOUS CURRENT ACCOUNT DEFICIT BY ADDING DIRECTLY AND INDIRECTLY TO IMPORT COSTS. SOME LOSSES IN EXPORTS COULD ALSO BE EXPECTED TO OCCUR. ALTOGETHER, THE NON-OPEC LDCS WOULD EXPERIENCE ROUGHLY A 1 PERCENT DETERIORATION IN TERMS OF TRADE FOR EVERY 5 PERCENT OIL PRICE RISE.

12. EACH 5 PERCENT PRICE RISE WOULD ADD $635 MILLION TO THE NET OIL IMPORT BILL FOR THE GROUP AS A WHOLE; THE BILL NOW STANDS AT $13 BILLION ANNUALLY. THE LARGE OIL-IMPORTING LDCS WOULD HAVE TO SPEND MORE THAN 1 PERCENT OF ANNUAL EXPORT EARNINGS JUST TO COVER A 5 PERCENT INCREASE IN THEIR OIL IMPORT COSTS. THE 50 OR SO LDCS THAT IMPORT ONLY ABOUT 10,000 B/D WOULD EACH PAY $2 MILLION MORE ON OIL, FOR EACH 5 PERCENT PRICE RISE.

13. EVEN THE NON-OPEC LDCS THAT ARE NOW NET OIL EXPORTERS MIGHT NOT COME OUT AHEAD. A RISE IN THEIR NON-OIL IMPORT COSTS AND A LOSS IN EXPORT VOLUME WOULD AT LEAST PARTLY OFFSET GAINS FROM HIGHER PRICES FOR THEIR OIL.

14. BY RAISING PRODUCTION COSTS IN DEVELOPED COUNTRIES, EVERY 5 PERCENT RISE IN OIL PRICES WOULD ADD ALMOST $450 MILLION TO DEVELOPING COUNTRIES' NON-FUEL IMPORT COSTS IN 1977. BY OUR CALCULATIONS, NON-OPEC LDC IMPORT PRICES FOR FOODSTUFFS, INTERMEDIATE PRODUCTS, AND FINISHED GOODS WOULD INCREASE 0.4 PERCENT ON THE AVERAGE IF OIL PRICES RISE 5 PERCENT.
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15. THE OIL-RELATED LOSS IN DEVELOPED COUNTRY REAL GNP ALMOST CERTAINLY WOULD HAVE AN ADVERSE IMPACT ON NON-OPEC LDC EXPORT VOLUME, BY REDUCING DEMAND FOR INDUSTRIAL RAW MATERIALS BELOW WHAT IT WOULD HAVE BEEN. WE ESTIMATE THAT THE VOLUME LOSSES ASSOCIATED WITH EACH 5 PERCENT OIL PRICE RISE COULD COST NON-OPEC LDCS ALMOST $200 MILLION. PART OF THESE LOSSES WOULD BE OFFSET BY OIL INDUCED PRICE RISES FOR EXPORTS OF MANUFACTURED GOODS.

DANGER POINTS

16. GIVEN THE IMPACTS WE ESTIMATE, HIGHER OIL PRICES WOULD POSE CONSIDERABLE RISKS TO THE ALREADY SLUGGISH PACE OF ECONOMIC RECOVERY. IF RECOVERY MOMENTUM CONTINUES TO LANGUISH OR WORSEN, THE OIL RELATED LOSSES IN REAL INCOME AND PRICE STABILITY COULD SPARK A NEGATIVE REACTION FROM CONSUMERS AND INVESTORS IN THE MAJOR COUNTRIES. AS IT IS, THE EXPECTED REBOUND IN INVESTMENT NEEDED TO KEEP RECOVERY GOING HAS FAILED TO MATERIALIZE. RECENT TRENDS IN INFLATION HAVE ALSO BECOME MORE WORRISOME IN WESTERN EUROPE AND JAPAN.

17. NON-OPEC LDC-, FOR EVERY 5 PERCENT OIL PRICE RISE, WOULD NEED AT LEAST $1.2 BILLION IN ADDITIONAL FOREIGN BORROWING TO MAINTAIN IMPORTS AND NOT SUFFER FURTHER LOSSES IN CONSUMPTION AND GROWTH. SINCE LDCS WOULD BE UNABLE TO DRAW DOWN EXCHANGE RESERVES MUCH, PRIVATE FINANCIAL INSTITUTIONS, INDUSTRIAL COUNTRY AID, AND MULTILATERAL LENDERS WOULD HAVE TO FINANCE THEIR NEEDS. GIVEN THE LARGE NON-OPEC LDC CURRENT ACCOUNT DEFICIT AND HUGE FOREIGN DEBT, IT REMAINS FAR FROM CERTAIN THAT THE FUNDS NECESSARY TO MAINTAIN IMPORT VOLUME WOULD BE AVAILABLE.

18. NON-OPEC LDCS: TRADE IMPACT OF HIGHER OIL PRICES

(AMOUNTS IN MILLIONS OF US DOLLARS).

--	15 PCT OIL PRICE RISE	10 PCT OIL PRICE RISE	5 PCT OIL PRICE RISE
OIL IMPORT BILL	1905	1270	635
NON-OIL IMPORT BILL	1350	900	450
EXPORT LOSSES	200	100	---

US FACT SHEET

19. OIL IMPORT COSTS. THE TOTAL FOREIGN COSTS OF US CRUDE OIL AND PRODUCT IMPORTS IN 1977 WOULD BE ABOUT $1.7 BILLION GREATER WITH EACH 5 PERCENT OPEC PRICE INCREASE.

20. PRODUCT PRICES. AVERAGE GASOLINE PRICES SHOULD INCREASE BY ABOUT 0.7 - 0.8 CENTS A GALLON IN 1977, FOR EACH 5 PERCENT OPEC PRICE INCREASE, ASSUMING THE CRUDE COST INCREASE WERE SPREAD EQUALLY ACROSS ALL PRODUCTS. (CURRENT GASOLINE PRICES AVERAGE ABOUT 60 CENTS A GALLON.) HEATING OIL PRICES WOULD ALSO RISE BY ABOUT 0.8 CENTS A GALLON ON A NATIONAL AVERAGE IN 1977 FOR EACH 5 PERCENT OPEC CRUDE PRICE INCREASE. (RESIDENTIAL HEATING OIL PRICES AVERAGED ABOUT 40 CENTS PER GALLON IN OCTOBER AND MIGHT INCREASE BY ABOUT 1.0 TO 1.5 CENTS A GALLON BY THE END OF THE CALENDAR YEAR WITH NO OPEC PRICE INCREASE). HEATING OIL PRICES IN NEW ENGLAND, BECAUSE OF ITS GREATER DEPENDENCE ON IMPORTED PRODUCTS, MIGHT GO UP ADDITIONALLY.

21. CONSUMER PAYMENTS FOR OIL. CONSUMER COSTS FOR OIL WOULD GO UP BY ABOUT $1.9 BILLION IN 1977, FOR EACH 5 PERCENT OPEC PRICE INCREASE, ABOUT A QUARTER OF A BILLION DOLLARS MORE THAN THE INCREASE IN THE COST OF FOREIGN OIL, BECAUSE OF THE STRIPPER WELL EXEMPTION. THIS EXEMPTION ALLOWS STRIPPER PRICES TO RISE TO THE WORLD MARKET LEVEL. ROBINSOM
UNQUOTE KISSINGER

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